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THE FEASIBILITY OF THE HUNGARIAN CONVERGENCE PROGRAMME

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Abstract

The paper provides on overview of the Hungarian Convergence Programme (CP) that envisages the path to restore macroeconomic equilibrium during the next three years. The spiralling budget deficit in 2006 made an update of the previous CP inevitable. In the September 2006 version the government shows strong commitment to face up to the fiscal imbalances and structural problems, yet several aspects question the feasibility of the Programme. The paper focuses on the evaluation of the major objectives and their realisation during the first year of the CP as well as on significant technical assumptions and external factors that may constitute a downside risk for the implementation. Besides introducing a corrective fiscal package the Convergence Program draws the outlines of several, long-awaited reforms of almost the entire sphere of the social welfare systems. As the primary focus is on the feasibility of the budgetary consolidation strategy, the paper deals with these reforms only in the context of the long-term sustainability of public finances.

Introduction

September 1, 2006 marked the deadline for Hungary`s first reelected government since 1990 to hand in the national Convergence Programme (CP) to the European Commission. The Programme endorses several painful adjustment measures in a frantic effort to put Hungary back on the balance track and to restore the credibility of the government in Brussels as well as on global financial markets. Besides drawing a scenario for reaching the Maastricht convergence criteria that is necessary for the Euro introduction, the CP also gives the broad outlines of the long awaited reforms of the social welfare systems.

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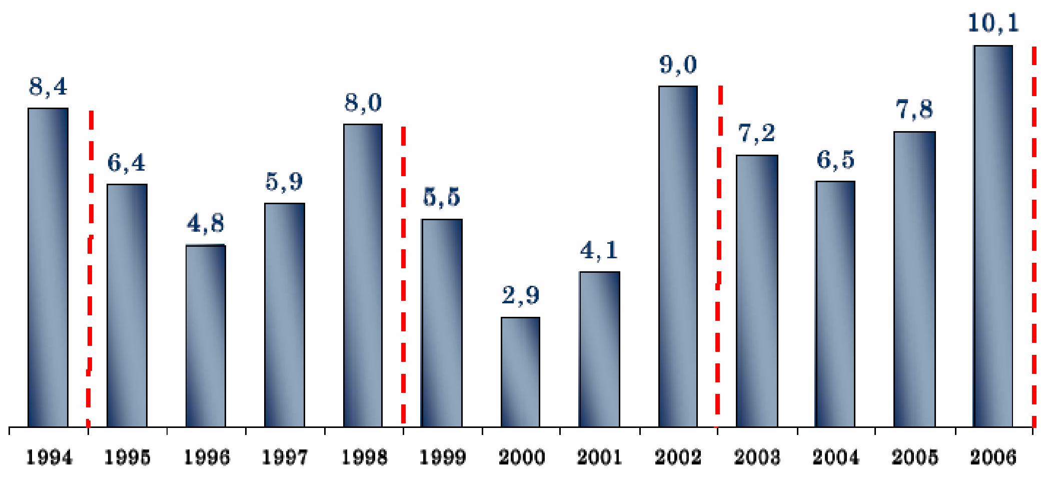
This paper provides an overview of the first year of the Convergence Programme, its macroeconomic background, the major steps and the possible effects. The analysis of the possible future challenges and risks focuses on the years 2007-2009 as this is the key period of the Convergence Programme, at the end of which fiscal balance and sustainable economic growth is expected to be restored. The CP contains only rough numbers for the period 2010-2011, which largely depend on the implementation of the restrictions during the first three years of the Programme. The paper gives only a broad overview of the planned educational, health care and pension reforms and only in the context of the long-term sustainablity of government finances as analysing all these areas and the feasibility of the reforms would be definitely far beyond the reach of this paper.

The background of the Convergence Programme

Election years do not usually enhance fiscal rigour but a roughly 10 % government deficit is still extraordinary. The Convergence Programme may finally break the „tradition" of election cycles that have been characteristic since the 1990s. (see Graph 1)

Graph 1: Government deficit in percentage of GDP, not including FISIM



Source: Hungarian Ministry of Finance

The necessity of the measures outlined in the CP is out of question. The excessive twin deficit as well as the growing debt ratio made the economic path in 2006 unsustainable. Hungary's macroeconomic performance is still the worst in the EU at the moment in terms of fulfilling the Maastricht convergence criteria, which has also created concerns in Brussels. Between 2007 and 2013 Hungary will receive 22.4 billion Euros development assistance from the EU[1] that can be at stake if the country does not show a macroeconomically sound and credible economic program to enhance convergence to the Maastricht criteria.

The EU gave the September 2006 deadline for the submission of the revised Convergence Programme, thus stressing not only the urgent need for reforms but leaving no room for political manoeuvre until the local elections in October.

Originally there were three scenarios to reduce the huge government deficit. The first visioned an extremely rapid adjustment, targeting the 3 percent criteria by 2008. The second, calculating with a relatively slow deficit reduction path, would have achieved this only by 2010. Finally, a third, relatively moderate slope was accepted that made 2009 the target date. This version is probably the most credible and realistic as an even more front-loaded effort would have raised a lot of concern about the feasibility of the Programme, while on the other hand, it was feared that with a relatively slower path the GDP growth rate would be stucked at a level of 2 percent for several years.

The current Programme, last updated in December 2006 still outlines an ambitious plan to reduce the government deficit by 7.5 % (or by 6.8 %, after the corrections in the calculation) by the end of 2009. (See Table 1) Even with this substantial cut, deficit will be slightly higher (3.2 %) than the required 3 % threshold but the government hopes that Brussels will take into account a part of the net cost of the pension reform in line with the revised Stability and Growth Pact.[2] In the case of Hungary, in 2009 this would correspond to 20 % of the net cost of the pension reform or an estimated 0.3 % of the GDP. The majority of the reduction falls within the first two years of the CP (2007-2008), the first year alone accounting to almost half of the decrease. This means an extremely large burden assigned to the Hungarian economy and society.

Table 1: Key indicators of the Convergence Programme

	005	**006**	**007**	**008**	**009**	**010**	**011**
Budget deficit (%							
Primary balance (%							
Gen. govt. debt (%							
CPI (change in %)							

Source: Convergence Programme of Hungary 2006-2010, December 2006 pp. 15-18.

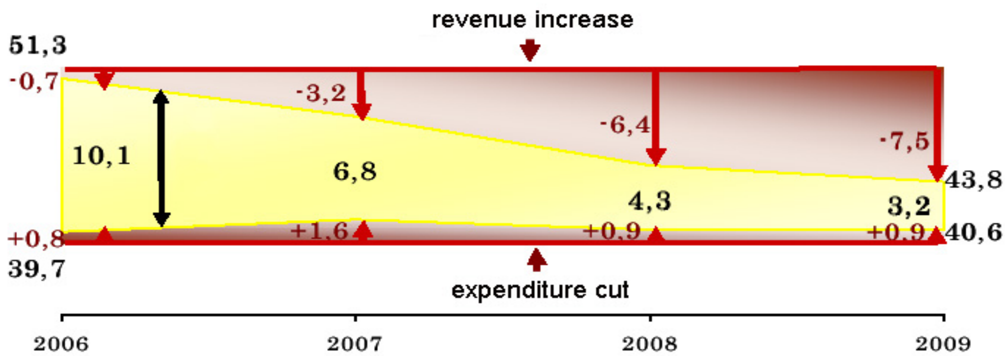
[1] The total sum amounts to approx. 30 billion euros including rural development assistance.

[2] According to Council Regulation (EC) No. 1056/2005, if the general government deficit „[…] has declined substantioally and continously and has reached a level that come close to the reference value the Council and the Commission shold consider degressively the net cost of a pension reform that includes a fully funded pillar".

Evaluation of the major elements of the CP

The key factor of the Convergence Programme is the steep and front-loaded reduction of the large government deficit as mentioned above. The Programme has often been criticised for being too focused on increasing revenues and neglecting the expenditure side. (See Graph 2) Revenues will be increased mainly by larger tax centralisation including higher VAT, corporate and personal income taxes as well as the introduction of new taxes (e.g. the property tax). The government has also officially abandoned its five-year tax cut programme that would have lowered budget revenues by around 3 % of the GDP by 2010.

Graph 2: Government deficit, revenues and expenditures in percentage of GDP (compared to the 2006 level without correction and not including EU transfers)



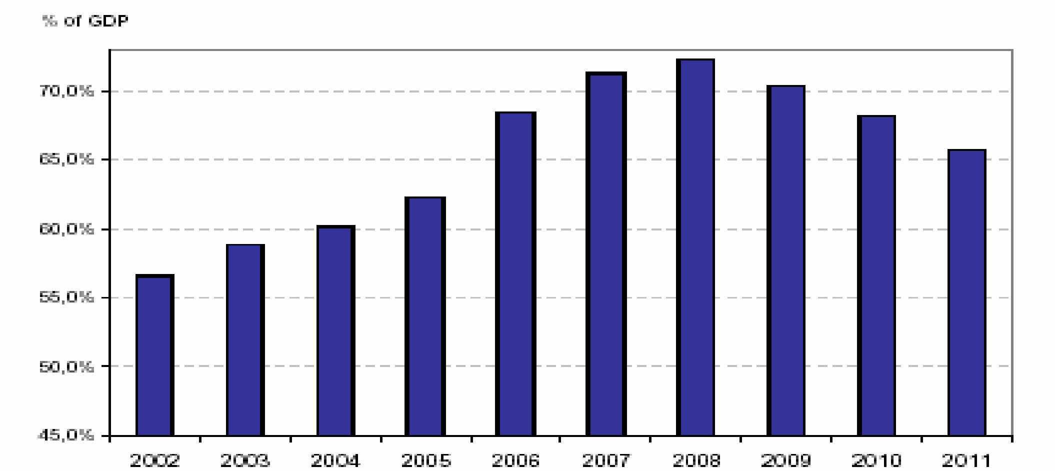
Source: Hungarian Ministry of Finance

Regarding the expenditure side, the idea that the government should start saving money on itself has become quite popular. Public administration and generally governmental organizations definitely deserve some streamlining, which would drastically affect public employment. Approximately 200 public organizations face transformation during the following years and the whole public sector is expected to operate on a 14 % less budget and with about 20 % less employees. This will definitely affect the labor market, although the government hopes that it can be offset by a moderate growth of the business sector, thus letting the unemployment rate increase only on the short run.

The CP broadly outlines the major directions of the long awaited reforms of the social welfare systems. The primary aim of these reforms is not only to cut expenses but also to improve the quality of public services provided by the central or local governments. There is no doubt that structural changes are inevitable, yet there is a lot of social resistance and suspition against the new measures. The complex reform of the educational, health care or pension systems is also on the agenda in old EU member states, however, the Hungarian social systems (and especially the pension system) constitutes an even higher risk regarding the sustainablilty of public finances. Hungary appears to be at an earlier stage of population ageing, and this, alongside with the still unresolved problems of the social welfare systems, threaten with long-term budgetary impacts. There are also voices of concern about the feasibility of the ambitious reforms while focusing on restoring the fiscal balance. Nevertheless, the greatest challenge that the Hungarian government faces nowadays is the successful and socially acceptable redefinition of the role of the state, meaning not only less redistributive and more market-driven solutions but also more effective and well-coordinated action in several areas.

An interesting point of the new Convergence Programme is the revised scenario for the public debt to GDP ratio, which is in sharp contrast with the previous versions. According to the current update of the CP, the gross government dept to GDP ratio is projected to significantly increase in 2006-2008 reaching its top (71.3 %) in 2008. This temporary rise can only be turned around in 2009 with the improvement of the primary balance as well as the revitalised economy and falling yields. Despite not reaching the Maastricht threshold even at the end of the programme period, the government hopes that Brussels would take into account the constantly and steadily decreasing pace of the debt to GDP ratio.

Graph 3: Public debt to GDP ratio



Source: Convergence Programme of Hungary 2005–2009 (September 2006) p. 35.

As for consumer prices, the Programme is highly optimistic by assuming that inflation will only temporarily accelerate during 2007 and than return to the previous path, though not reaching the expected Maastricht level for several years. However, recent estimations of the National Bank have projected CPI as high as 8.5 % for the first eight months of 2007, so the inflation target for this year will probably have to be updated again. On the other hand, minor divergence from the original numbers may be calculated with, as the National Bank itself sets only a mid-term inflation target (3 percent), thus leaving room for adjustment on the short run.

Disinflation in the past few years in Hungary was partly artificial as it was partly due to regulated prices that kept especially energy prices lower than world prices (e.g. electricity, natural gas prices) and the VAT reduction that took place at the end of 2005. In line with the decision to transform the subsidy system for energy, pharmaceuticals, transportation prices as well as to raise the V/AT level of 15 % to 20 %, inflation will accelerate considerably in 2007. A stronger exchange rate and lower oil prices can influence this trend positively but the biggest responsibility still lies with the proper implementation and the credibility of the Convergence Programme as this can keep inflation expectations moderate.

The document is often criticized for cautiously avoiding setting an exact date for the Euro adoption. However, Hungary stands not alone with this kind of mysterious unpredictability in the region. Poland has not even attempted to predict an official date, although there have already been unofficial statements of a 2012-2013 introduction. 2012 may also be the target date according to the new national plan of the Czech Republic, however, nothing seems to urge Prague either. It is still Slovakia that seems most determined to undertake the promise of the previous government about the 2009 accession, even postponing the fulfilment of several campaign slogans with this end. It is an interesting question why and how the once leading Central European group lost its comparative advantages in the ”Euro race”, even compared to the Baltic states.[1]

Although not announced officially, 2013 or more probably, 2014 can be the accession date for Hungary – provided that the measures of the CP will be implemented. Relatively late adoption of the Euro is not necessarily a drawback if policy makers finally realise that not premature, unprepared introduction, but a well-coordinated, predictable and credible pace of accession adjusted to the realistic economic and political capacities serves the country's interests best.

[1] Though having excellent fiscal indicators, Estonia and Latvia already had to postpone the introduction of the single currency as a result of high inflation rates. It is a common problem of the new member states trying to catch up quickly that due to their overheated economy and extremely high GDP growth rates (approx. 10 % in the Baltic states) they are unable to keep the inflation criterion.

Credibility also remains a key element in determining the behaviour of foreign investors. If government measures are transparent and consistent with the major objectives of the national programs (including mainly the National Strategic Reference Framework besides the Convergence Programme), a relatively short delay will probably cause no direct threats. However, an even further delayed accession may result in the relative devaluation of Hungary's position as well as a rearrangement of foreign direct investments that are vital for the Hungarian economy.

The biggest question remains if the economy can recover from the surgery as quickly as it is supposed to according to the Programme. The CP assumes that GDP growth rates as well as inflation will be affected negatively only on the short run and the economy can return to its previous dynamism as early as 2009. This is extremely important as by 2006 Hungary fell behind in terms of GDP growth rate even among the Central European countries.

Assumptions and external factors

The assumptions of the Convergence Programme definitely include factors of uncertainty that may cause some divergence from the baseline results. There are basically five assumptions of the CP that either seem unrealistic or are far beyond the reach of the government.

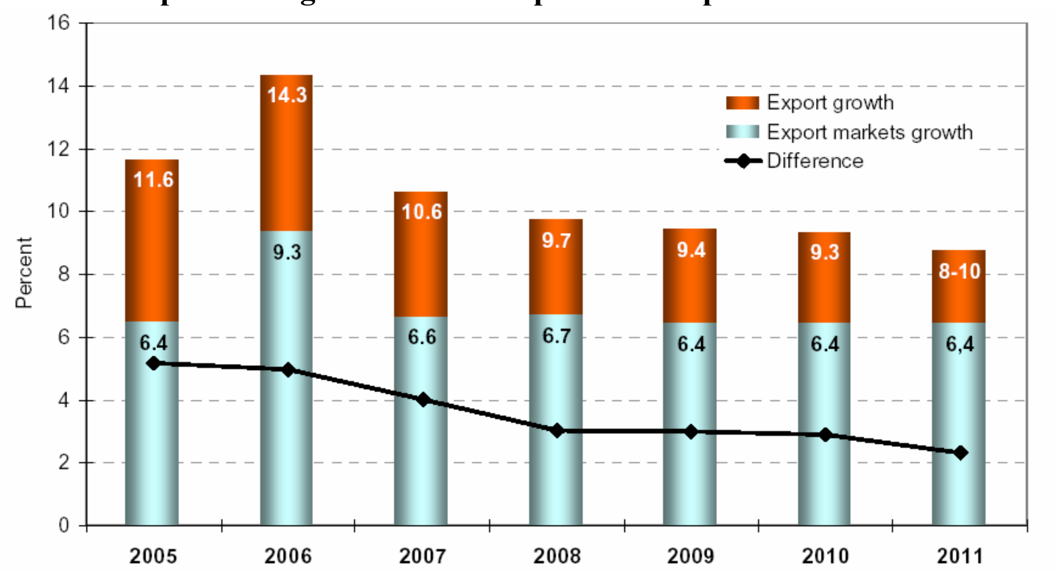
The first factor that cannot be influenced by the government but definitely plays a key role in the realisation of the Programme is world- and especially EU GDP growth. The CP relies on the forecast of the European Commission that assumes a 2.0 – 2.2 percent GDP growth rate for the years 2007-2009. Although this rate seems realistic for 2007 and according to recent projections, the EU GDP may reach even higher dynamism mainly due to the German economy[1], a possible slowdown may pose risks for the implementation of the Programme.

A second and recently overdiscussed topic is the question of energy prices. The Programme calculates with stable oil prices using a model of 70 USD/bbl for the period of 2007-2009. This can certainly be challenged by a sharp increase resembling that of last summer but the government assumes that a 15 USD/barrel difference can be still managed within the baseline results of the Programme. Considering that a possible increase rather affects the current account balance than the amount of revenues, this optimism can be at least partly explained.

[1] As a result of recent positive changes, the September version was slightly reviewed and the actual Program projects 2.2 – 2.4 percent EU GDP growth.

However, there is no reason for such optimism in the case of investments and export dynamism. As apart from capital investments, growth will remain mainly export-driven in the following years, any negative changes may have large spill-over effects. The export projection is primarily based on the growth of external demand that is supposed to remain relatively stable, thus gradually reaching a better trade balance, with a possible surplus in 2011. On the one hand, the Hungarian export is quite vulnerable, with almost half of it originating from short production lines that are placed in Hungary only for a specific phase of the production. On the other hand, external demand and the growth of foreign markets largely depends on the growth of the EU economy.

Graph 3: The growth rate of exports and export markets



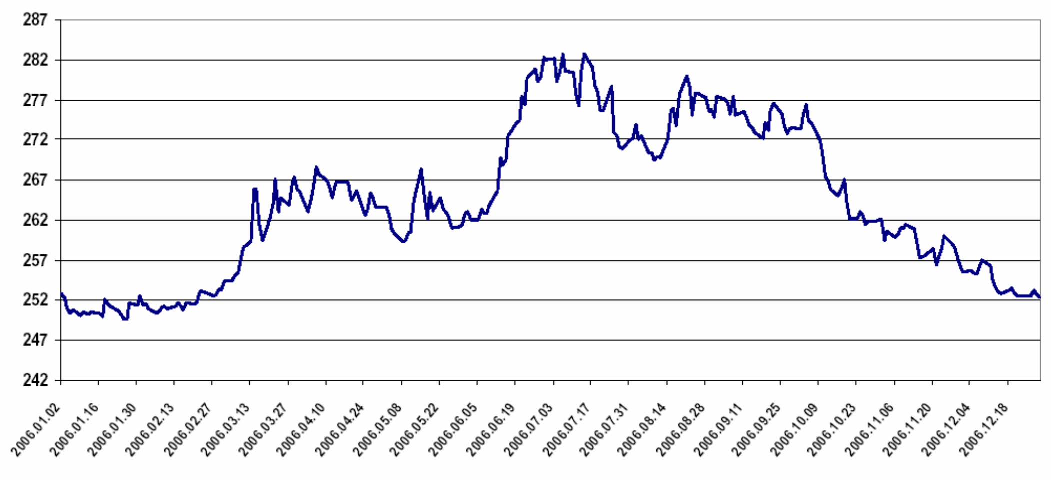
Source: Convergence Programme of Hungary 2006-2010, December 2006 p.10.

As for investments, household income and therefore available resources for investment will decline especially in the first two years of the CP due to the stabilisation measures and a temporarily higher inflation. However, according to the projections, investment ratio will reach 25 % by 2009, which seems too optimistic. The government hopes to enhance investment dynamism with the increased use of EU resources and cofinanced national investment projects, mainly in the fields of transportation systems, renewable energy sources and health infrastructure.

A final assumption of the model is about the exchange rate – the Programme calculates with a technical rate of 271 HUF/Euro for the period of

2007-2009.[1] Since 2001, Hungarian monetary policy has been focusing primarily on inflation targeting, accompanied by a wide-band pegged exchange rate system. The exchange rate may fluctuate against the Euro within a band of +/- 15 %. The national currency was markedly stable until the end of 2005, but fluctuated greatly during 2006, and there were even projections about a possible 300 HUF/Euro rate. However, after the Commission and the Ecofin gave a positive response to the Convergence Programme, the exchange rate began to strengthen indicating the growing trust of the markets. The first two reports in April and September 2007 already calculated with a technical rate of 254 and 251 HUF/Euro, respectively. Following significant appreciation of the national currency in the last few months the debt stock was effected very positively.[2] Thus, the exchange rate seems to pose a smaller threat to the feasibility of the CP but this can change during a three-year period.

Graph 4: The HUF/Euro exchange rate in 2006



Source: Ministry of Finance

A key element of the CP is the projected GDP growth that is partly derived from the assumptions described above. As a result of the fiscal consolidation, domestic demand will decrease sharply in the first two years of the Programme. GDP growth will significantly slow down and the real output level will drop below the potential output. As a result, the output gap will become negative, reaching approximately -2 % of the potential output in 2008-2009.

[1] This data was also slightly modified as the previous version used an exchange rate of 272.5 HUF/Euro.

[2] Approximately 30 % of the debt portfolio is denominated in foreign currency (essentially in Euro), so a 10 % exchange rate change would have about 2.0 percentage point impact on the debt ratio.

According to the objectives of the CP, from 2009 real GDP growth will accelarate and rise to the level prevailing before 2007, which is a very positive scenario (see Table 2 for detailed data). The December version of the CP includes some slightly positive adjustments mainly due to the better global and Hungarian economic performance that gave birth to some even more optimistic projections assuming that the Hungarian economy can reach its growth potential even earlier than expected. However, even with these optimistic assumptions the possible growth sacrifice is significant, leaving a slightly negative output gap even in 2011.[1] This growth sacrifice could be partly reduced by proper adjustment of the national development programs, mainly the National Strategic Reference Framework (NSRF – also called New Hungary Development Plan in Hungarian). The NSRF should focus on such economic programs that can have a positive impact already on the short run and strenghten economic growth by enhancing competitiveness, employment and domestic demand, thus making up for part of the negative effects of the CP.

Table 2: GDP components and growth

annual percentage change

	2005	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**
Household	3.8	2.4	-0.8	0.0	1.8	2.7	cca.3
Government	0.2	2.6	-1.6	-3.3	1.6	1.6	1.5-2
Investment	5.6	2.8	2.4	4.0	7.5	6.8	6-8
Domestic	**1.4**	**2.0**	**0.3**	**0.7**	**3.3**	**3.7**	**cca.4**
Exports (goods and	11.6	14.3	10.6	9.7	9.4	9.3	8-10
Total demand	5.3	6.8	4.6	4.7	6.2	6.4	6-7
Imports (goods and services)	6.8	11.1	8.1	7.5	8.6	8.9	8-10
GDP (at 2005 year	**4.2**	**4.0**	**2.2**	**2.6**	**4.2**	**4.3**	**cca.4.5**
Potential GDP	4.0	4.1	4.0	3.9	3.9	3.8	3.8
Output gap	**1.3**	**1.2**	**-0.6**	**-1.8**	**-1.5**	**-1.0**	**cca. -0.5**

Source: Convergence Programme of Hungary, December 2006, pp. 9-13.

The Convergence Programme also admits the relevance of the risks deriving from the factors mentioned above. Though it is based on assumptions

[1] Data and estimation is based on the Convergence Program that uses the Cobb-Douglas production function for the calculation of the potential GDP following the methodological recommendation of the Commission.

and estimations achievable with the highest certainty, calculations have also been made for different macroeconomic tendencies. The September version introduces for the first time alternative scenarios, namely four, reduced to three by the December update. They are based on mainly two variables: domestic and external demand.[1] The more positive and more negative projections basically fall within a +/- 0.3 percent band from the baseline scenario in terms of GDP growth difference, which means a maximum of -0.3-0.4 percentage point divergence for the budget balance (in percentage of GDP). According to government projections, this risk can be offset with reserves and reserve measures built into the budget. These include the newly introduced property tax or the equilibrium reserve that both account for approximately 0.3 percent of the GDP but are not shown on the revenue side yet.

Evaluation of the first year of the Programme[2]

The government has to report every six months the results and drawbacks of the Convergence Programme to the Commission and the Council, also including the implementation of the structural reforms. The first report was due in April 2007 and adopted by the Council in July, while the second was just submitted at the end of September. Both reports stress that macroeconomic tendencies have developed largely along the path envisaged in the Convergence Programme, and in certain aspects, they even intruduce some slightly positive upgrades. (See Table 3)

Table 3: Macroeconomic forecasts for 2007

	CP 2006 Dec	*2007 Apr*	*2007 Sept*
GDP growth (%)	2.2	2.2	2.2
CPI (%)	6.2	7	7.5
Budget deficit (% of GDP)	6.8	6.6	6.4
Gross govt. dept (% of GDP)	67.5	66.2	65.5

Sources: Hungarian Ministry of Finance: First and Second Report on the measures taken in response to Council recommendation of 10 October 2006 under Article 104(7) of the Treaty

[1] The scenario based on higher oil prices and higher inflation was removed from the December update.

[2] Based on the First and Second Report on the measures taken in response to Council recommendation of 10 October 2006 under Article 104(7) of the Treaty (Published by the Hungarian Ministry of Finance)

As for the GDP growth rate, the large-scale fiscal consolidation has resulted in expected output losses. In 2006 GDP growth rate was 3.9 %, which is only slightly below the potential growth rate, however gradually decelarated during the year and especially in the first half of 2007. For the second quarter, growth rate has only reached 1.2 % in contrast to 2.7 % for the first quarter of 2007.

On the expenditure side, GDP deceleration was caused mostly by the marked drop in final consumption, in particular in social transfers in kind, which were reduced significantly (by 9% in the first half of the year) by the cuts in health care expenditure. Despite the more than 6% real wage drop, household consumption expenditure has not declined considerably: households smoothed their consumption significantly. However, the most direct effect on the society has probably been the significant fall of real wages. In the first six months of 2007, the real wage drop was more than 9% in the public sector and around 5% in the private sector. The higher-than-expected wage growth along with the higher employment growth in the private sector was partly due to the whitening of the business sector as a result of government measures taken in late 2006.

In the first half of 2007, both exports and imports increased dynamically; net exports continued to have a positive impact on GDP growth (1.4%). No drastic drop in external demand is expected for the second half-year, thus in the whole year, export may increase by about 15% and import by about 12%. The balance of goods and services trade is expected to produce an export surplus again, mostly because of the approximately 1 billion euro improvement in the trade balance over the previous year figure. Relating to these developments, the current account deficit may also be lower than the level indicated in the Convergence Programme, only slightly exceeding 4% of GDP.

The investments in the economy were lower than projected in 2006 and their dynamism in 2007 continues to be surrounded by uncertainty. A decline is likely in state-financed investments, and no growth is projected in housing construction, a driving force behind the investments of households. In contrast, high capacity utilisation, growing EU transfers and a favourable export outlook may all have a positive impact on the willingness of businesses to invest.

In the first eight months of the year, the average rate of inflation was 8.5%. This trend is roughly in line with expectations, but it is above the forecast, mostly due to the fast price rises of certain non-processed food products. On the whole, the government measures of last autumn and early this year had the calculated inflationary effect.

The most visible positive progress is in the fiscal numbers. The budget act set the general government deficit for 2007, in accordance with the Convergence Programme, at 6.8% of the GDP. The report on the implementation in April, reckoning on the positive changes that were emerging at the time, set out a deficit forecast of 6.6% that was further upgraded to 6.4 % in the second report. This was attributable to the surplus of tax and contribution revenues, which increasingly appears to be a permanent development, and to the tight control on expenditures, which in certain areas proved to be even lower than expected. Along with the lower deficit, the new projection contains a 0.4% of GDP higher risk reserve and central equilibrium reserve than the April figures.

There are also signs of a possible slow-down of the rise of the public debt ratio. By the end of 2007 the September 2006 CP forecasted a 70.1 % debt ratio that was modified to 67.5 % in December and to 66.2 % in the April report. The last update showed even more positive intra-year developments. The exchange rate appreciated considerably, therefore, the technical exchange rate assumption used for the debt forecast is even stronger than the one in the April report. The actual debt ratio for the first eight months of 2007 was 65.5 % of the GDP, thus projecting a more modest rise than expected by the Convergence Programme.

On the whole, both government reports state that progress was made along the path assumed by the Convergence Programme and it seems that the most crucial part of the front-loaded deficit reduction will be fulfilled by the end of this year. The Commission and Council opinions have also affirmed these positive developments, however warned that only a consistent, tight fiscal policy and coherent structural reforms may guarantee the long-term sustainability of the processes.

The feasibility of the CP

Besides the major challenges arising from the internal and external factors described above the key element of the Convergence Program is credibility. Credibility has several dimensions and aspects, the first of which is international. Although several slight downgrades in terms of credit rating have shown diminishing international confidence in Hungary, the Commission as well as the Ecofin indicated their support for the CP by the quick approval of the Programme. However, Hungary has to pay more attention to the consistency and the implementation of the measures. Especially the September 2006 version marked a large and negative update to the previous programmes while the December update along with the first and second reports in 2007 meant some slightly positive changes. (See Table 4)

Table 4: Divergence of the September 2006 CP from the 2005 update

		2005	**2006**	**2007**	**2008**	**2009**
Real GDP growth (%)	CP 2005	4.2	4.3	4.1	4.1	-
	CP 2006 Sept	4.1	4.1	2.2	2.6	4.1
Govt. deficit (% of	CP 2005	7.4	6.1	4.7	3.4	-
	CP 2006 Sept	7.5	10.1	6.8	4.3	3.2
Gen. govt. gross debt	CP 2005	61.5	63.0	63.2	62.3	-
(% of GDP)	CP2006 Sept	62.3	68.5	71.3	72.3	70.4

Source: Convergence Programme of Hungary 2005–2009 (September 2006). p. 63.

On the other hand, domestic credibility and legitimacy of the CP is a more delicate issue. The success of the fiscal tightening will largely depend on the social capacity and willingness to accept the increased burden. As the example of the Slovenian inflation reduction has shown in recent years, quick and efficient measures can only be based on widespread social and economic consensus. As the majority of the Hungarian deficit reduction is based on increased taxation, the main issue will remain if all the expected tax revenues can be collected. The adjustment measures may push an even larger part of the society towards the grey and black economy, the size of which is already substantial.

The incredibly low social acceptance of the government measures is mainly due to two factors. First, the center-right opposition suggests that there would be an alternative, less painful scenario for deficit reduction and social reforms without giving exact details and analysis about the alternative programmes. However, according to the logic of the Hungarian quasi-two party system, the opposition is not interested in taking part of the responsibility in the ongoing programmes, thus undermining any substantial changes or reforms that would require a qualified majority decision as well as ruining the possibility of any widespread social consensus. On the other hand, the ruling socialist – liberal democrat coalition is responsible not only for the major part of the broken equilibrium but also for the poor communication results. The majority of the Hungarian society does not understand the necessity of the programmes and even if they agree with the diagnosis of the major problems and some of the solution attempts, they do not see how these random, undeveloped measures will form a coherent and well-defined programme.

Short-term fiscal consolidation is definitely easier than reaching long-term sustainablity of government finances and the social welfare systems. The government shows high commitment towards the implementation of the programmes and seems ready to perform tighter fiscal discipline. A recently passed act allowing only a surplus of the primary balance from 2008, as well as the close supervision of the EU can safeguard this.

The feasibility of the structural reforms is a more complex issue. Economy as well as politics is made on double levels: besides a national one there exists a community level of decision-making. The community level can empower national governments to carry out difficult reforms, however, it may also serve as an excellent excuse for their failure to undertake unpopular policy decisions. Hopefully, the current reforms in Hungary will be rather fueled by Brussels` determination to welcome only economically sound new members in the Eurozone. Hungary has already paid a large price for having continuously postponed some vital reforms. If the present programme means no real, profound changes, just a new facelift on the old body of the social welfare system, that price will still increase.

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